BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NO. 16240
[REDACTED]	)	DECISION
	)	
Petitioner.	)	
	)	

[Redacted] (petitioner) protests the Notice of Deficiency Determination issued by the auditor for the Idaho State Tax Commission (Commission) dated October 26, 2001, asserting additional liabilities for Idaho income tax and interest in the total amounts of $8,096 and $6,848 for 1998 and 1999, respectively.

The auditor for the Commission made several adjustments to the petitioner's computations for his income tax returns. All of the adjustments except one have been agreed to by the petitioner. The one remaining issue to be resolved is whether the income from sales of certain subdivided real property is eligible for the Idaho capital gains deduction or, alternatively, whether the income constitutes ordinary income from the sale of property held primarily for sale to customers in the ordinary course of a trade or business.

The subject real property has been owned since 1969. The [Redacted] ([Redacted] and his parents) have owned and operated a construction business on the property for an extended period of time. Development of the surrounding property made it more desirable to subdivide the excess property around the business location. Therefore, the property was platted in 1996 and 1997 with sales following. The average sales price of the lots was about $30,000.

The petitioner contends that the sales of the subject property fall within the provisions of Internal Revenue Code § 1237. The auditor contends that the protection provided by Internal Revenue Code § 1237 does not apply and that, therefore, the income from the sales should be

considered to be ordinary income. If the sales come within the parameters of Internal Revenue Code § 1237, the Idaho capital gains deduction is allowable. If the sales do not come within the provisions of Internal Revenue Code § 1237, then the Commission must further determine whether the property was held for sale in the ordinary course of business. If the property was so held, then the capital gain deduction is not allowable and the auditor's determination must be upheld.

On February 5, 1998, the [Redacted] Land Use and Development Commission considered and approved the [Redacted]application for [Redacted] Industrial Park 1st addition. The report from that meeting indicated that the streets should be paved within two years. In a "Pre-construction conference checklist" dated May 12, 1998, the "general requirements sequence of operations" indicates that the sequence should be sewer, water, utilities, and then the paved road.

One of the qualifications for treatment under Internal Revenue Code § 1237 is that, "no substantial improvement that substantially enhances the value of the lot or parcel sold is made by the taxpayer on such tract while held by the taxpayer or is made pursuant to a contract of sale entered into between the taxpayer and the buyer." There are two parts necessary to disqualify the property pursuant to this provision. First, the improvement must be "substantial." Second, the improvement must substantially enhance the value of the property.

The petitioner urges the Commission to find that this situation falls within the provisions of subsection (3) of Internal Revenue Code § 1237 which states:

> Necessary Improvements. – No improvement shall be deemed a substantial improvement for purposes of subsection (a) if the lot or parcel is held by the taxpayer for a period of 10 years and if –
>
> > (A) such improvement is the building or installation of water, sewer, or drainage facilities or roads (if such improvement would except for this paragraph constitute a substantial improvement);
> > (B) it is shown to the satisfaction of the Secretary that the lot or parcel, the value of which was substantially enhanced by such improvement, would not

> have been marketable at the prevailing local price for similar building sites without such improvement; and
> (C) the taxpayer elects, in accordance with regulations prescribed by the Secretary, to make no adjustment to basis of the lot or parcel, or of any other property owned by the taxpayer, on account of the expenditures for such improvements. Such election shall not make any item deductible which would not otherwise be deductible.

The method for making the election referred to above is governed by Treasury Regulation § 1.1237-1(c)(5)(iii) which provides:

> Manner of making election. The election required by section 1237(b)(3)(C) shall be made as follows:
> (a) The taxpayer shall submit:
> (1) A plat showing the subdivision and all improvements attributable to him.
> (2) A list of all improvements to the tract, showing:
> (i) The cost of such improvements,
> (ii) Which of the improvements, without regard to the election, he considers "substantial" and which he considers not "substantial."
> (3) A statement that he will neither deduct as an expense nor add to the basis of any lot sold, or of any other property, any portion of the cost of any substantial improvement which substantially increased the value of any lot in the tract and which either he listed pursuant to subdivision (2)(iii) of this subdivision or which the district director deems substantial.
> (b) The election and the information required under subdivision (a) of this subdivision shall be submitted to the district director –
> (1) With the taxpayer's income tax return for the taxable year in which the lots subject to the election were sold, or
> (2) In the case of a return filed prior to August 14, 1957, either with a timely claim for refund, where the benefits of section 1237 have not been claimed on such return, or, independently, before November 13, 1957, where such benefits have been claimed, or
> (3) If there is an obligation to make disqualifying improvements outstanding when the taxpayer files his return, with a formal claim for refund at the time of the release of the obligation , if it is then still possible to file a timely claim.

In this case, the petitioner did not submit a plat with his returns and failed to meet some of the other qualifications for the filing of a valid and timely election. Therefore, this treatment is not available.

Still, to be disqualified from § 1237 treatment due to the improvements, the improvements must be substantial and they must substantially enhance the value of the property. Treasury Regulation § 1.1237-1(c)(4) addresses the issue as follows:

> When an improvement is substantial. To prevent the application of section 1237, the improvement itself must be substantial in character. Among the improvements considered substantial are shopping centers, other commercial or residential buildings, and the installation of hard surface roads or utilities such as sewers, water, gas, or electric lines. On the other hand a temporary structure used as a field office, surveying, filling, draining, leveling and clearing operations, and the construction of minimum all-weather access roads, including gravel roads where required by the climate, are not substantial improvements.

In this case, the petitioner and his father have agreed to install utilities and hard surface roads. Therefore, the improvements are substantial. The only remaining issue is whether such improvements substantially enhanced the value of the property. Since this case involves the allowance of a deduction, the petitioner must bear the burden of proof. The U.S. Supreme Court stated in New Colonial Ice Company, Inc. v. Helvering, 292 U.S. 435, 440 (1934) that "[w]hether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed." They further stated that "[o]bviously, therefore, a taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms." The information provided by the petitioner provides no data from which to make this determination. Therefore, the Commission finds that the petitioners have failed to carry their burden of proof that the value of the property was not significantly enhanced.

The petitioner's argument is directed entirely to Internal Revenue Code § 1237. However, if aside from the provisions of that section, petitioners did not hold the property for sale to customers in the ordinary course of their trade or business, the sales would appear to be sales of capital assets and would qualify for the Idaho capital gains deduction. The Commission must consider whether

the petitioner held the property in the years here in question for sale to customers in the ordinary course of his business.

Whether property is held by a taxpayer primarily for sale to customers in the ordinary course of his trade or business is essentially a factual question. Guardian Industries v. Commissioner, 97 T.C. 308, 316 (1991).

To determine whether property was held for sale in the ordinary course of a taxpayer's trade or business, it must first be determined whether the taxpayer's activity with regard to the property has risen to the level of a trade or business:

> . . . the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify. Commission v. Groetzinger, 480 U.S. 23, 35 (1987).

In this case, the petitioner's real estate activities were more than a sporadic activity. Substantial changes were made in the property. Several lots were sold.

> In a real estate activity the following factors, among others, should be considered in determining whether the property was held for sale in the ordinary course of a taxpayer's trade or business: (1) The nature and purpose of the acquisition of the property and the duration of the ownership; (2) the extent and nature of the taxpayer's efforts to sell the property; (3) the number, extent, continuity and substantiality of the sales; (4) the extent of subdividing, developing and advertising to increase sales; (5) the use of a business office for the sale of the property; (6) the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and (7) the time and effort the taxpayer habitually devoted to the sales. United States v. Winthrop, 417 F.2d 905, 910 (5th Cir.1969).

While information concerning some of these factors is absent from the file, evidence of the petitioner's development activity is available. The extent of development activity and improvements is an important factor in deciding whether the real estate activity is a trade or business. Suburban Realty Co. v. United States, 615 F.2d 171, 178 (5th Cir. 1980).

The burden to show that the sales were of a capital asset is on the petitioner. English v. Commissioner, T. C. Memo 1993-111. The Commission finds that he has not met this burden.

WHEREFORE, the Notice of Deficiency Determination dated October 26, 2001, is hereby APPROVED, AFFIRMED, and MADE FINAL.

The amounts set forth in the Notice of Deficiency Determination have been paid in full; therefore, no further demand is made.

An explanation of the petitioners' right to appeal this decision is enclosed with this decision.

DATED this _____ day of _____, 2002.

IDAHO STATE TAX COMMISSION

_____
COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of _____, 2002, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in envelopes addressed to:

[Redacted]

_____